State of North Carolina
Office of the State Controller

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STATE CONTROLLER

October 5, 2010

MEMORANDUM

TO: Chief Fiscal Officers
Vice Chancellors

FROM: David T. McCoy

SUBJECT:
I. 3% Federal Tax Withholding Requirement *(Tax Increase Prevention and Reconciliation Act of 2005)*
II. Information Reporting of Goods and Services (*Patient Protection and Affordable Care Act of 2010)*
III. Payment Card and Third Party Network Transactions *(Housing Tax Assistance Act of 2008)*

There are three major federal tax reporting and withholding provisions that are scheduled to become effective soon. The first two federal tax withholding and reporting provisions set forth above will go into effect January 1, 2012. The third listed concerns reporting of payment card and third party network transactions (including benefit payment cards issued by governments) which will become effective January 1, 2011. Unless these tax provisions are delayed or repealed by Congress, they will have a significant impact on the accounting and reporting operations of State agencies and institutions.

The following is a basic outline of the reporting requirements of these three tax provisions:

I. 3% Federal Income Tax Withholding, Beginning January 1, 2012

A. Amounts Subject 10 3% Section 3402(t) Withholding

Every state is required to withhold 3% of payments for property or services **with the following exceptions:**

1. Wage payments to employees,
2. Payment subject to backup withholding,
3. Interest payments,
4. Payments for real property,
5. Payments to other governments, tax-exempt entities,
6. Classified contracts (IRC 6050M)

7. Made by a political subdivision of a state which makes annually $100 million in payments, or less
8. Payments for public assistance or public welfare that is determined on a needs or income basis,
9. To any government employee not otherwise excludable with respect to his service as an employee, travel and transfers to pension plans,
10. Other payments exempted from withholding:
    a. Social security benefits,
    b. Unemployment compensation,
    c. Disaster payments,
    d. CCC loans that taxpayer has elected to treat as income,
    e. Payment of annuities to individuals,
    f. Payments made to NRA that are exempt from US tax due to Treaty are exempt from 3402(t)

B. Persons subject to the withholding under Section 3402(t)

1. Individuals,
2. trusts,
3. estates,
4. partnerships,
5. associations,
6. companies, or
7. corporations.

C. Payments subject to Section 3403(t) withholding:

1. Payments made by government or its payment administrator of **$10,000 or more,**
2. multiple payments do not have to be aggregated unless abuse present,
3. anti-abuse rules require aggregation if purpose of multiple payments is to avoid 3402(t) rules.

D. Payment Administrator:

Payment administrator is defined as any person that acts with respect to a payment solely as an agent for a government entity. Transfers from the government to the payment administrator are exempt but payments for the fees of the payment administrator are subject.

E. Credit Card Payments:

Payments made by credit cards and procurement cards are subject to the 3% withholding at the point of sale, not when the government makes the payment to the bank.

F. Depositing and Reporting Amounts Withheld Under IRC Section 3402(t)

Form 945, <u>Annual Return for Withheld Federal Income Tax to be used,</u>
Form 1099-MISC, <u>Miscellaneous Income</u> to be used to report amounts to recipients

G. **Effective Date and Transition Relief for Existing Contracts:**
Effective for payments made after December 31, 2011. Contracts already in existence prior to existence of Section 3402(t) are exempt unless substantially modified subsequent to effective date.

In summary, Section 3402(t) withholding requires large governments to withhold 3% of payments for goods and services made in the amount of $10,000, or more. As stated above, there are several exceptions to this withholding requirement, both as to transaction type, and as to subject payee. IRS Form 1099-MISC will be used to report the withheld tax, and a strict tax deposit schedule, which is set forth in the instructions for Form 945 tax, must be followed. Form 945, also requires a monthly listing of when the tax was withheld from payee which the IRS will electronically match to the payor's tax deposit for purposes of generating late deposit penalties, if not timely remitted to the IRS.

OSC is presently working on a NCAS system upgrade, modification, and procedures to comply with the IRC Section 3402(t) tax withholding and reporting requirement. Instructions for NCAS agencies will be issued as this tax provision's effective date comes closer.

Agencies and institutions not on NCAS should begin work on necessary system modifications and establishing procedures to be in full compliance with IRC Section 3402(t) 3% tax withholding requirements.

II. Information Reporting of Goods and Services, Beginning January 1, 2012

The Patient protection and Affordable Care Act of 2010 amended IRS Code Section 6014(h) to require payments made to corporations be reported on Form 1099-MISC, just as we currently report payments made to individuals. In addition, the "PPACA" requires payments for both **goods and services** to be reported to the IRS on Form 1099-MISC, effective January 1, 2012.

IRS Notice 2010-51 invited public comments on the implementation and operation of this new reporting requirement. This Notice states payments for interest, dividends, royalties and broker transactions will not be subject to the expanded reporting requirements. Also, governments and tax-exempt organizations will continue to be exempt from receiving a Form 1099 for both goods and services.

The IRS states in this same notice that it will attempt to avoid duplicate reporting. Also, payments subject to the payment card and third party reporting requirements (see below) will be exempt from the expanded 1099 reporting requirements of IRC Section 6014(h).

Until the IRS issues regulations further explaining the expanded 6014(h) requirements, there will remain many unanswered questions. However, it is very clear the name and TIN combination of corporations, as well as other business entities that sell property to State agencies and institutions and were not previously subject to Form 1099 reporting, will have to be completely accurate so that we can comply with this tax provision.

Again, further instructions will be forthcoming concerning this expanded 1099 reporting requirement. Agencies and institutions should take action to insure the vendor name/TIN combinations, for both corporations and non-corporate vendors selling goods and services to State agencies or institutions, are absolutely correct.

III. Payment Card and Third Party Network Transactions, Beginning January 1, 2011

Treasury Decision 9496, issued by the IRS on August 13, 2010, sets forth final regulations for IRC Section 6050W, concerning 1099 information reporting of payments made in settlement of payment card and third party payment transactions. The following is a brief outline of the basic provisions of this IRS Regulation:

1. **Definitions:**
   Payment settlement entity – in the case of a payment card transaction, a merchant acquiring entity; and in the case of a third party network, a third party organization.

   Merchant acquiring entity – the bank or other organization with the contractual obligation to make payment to participating payees in settlement of payment card transaction.

   Third party settlement organization – the central organization that has a contractual obligation to make payment to participating payees of third party network transactions.

If two or more persons qualify as payment settlement entities for a reportable payment transaction, then only the payment settlement entity that in fact makes payment in settlement of the reportable payment transaction is obligated to report the payment.

2. **Amount to Report:**
   Each payment settlement must report the gross amount of reportable payment transaction. This is the total dollar amount without regard for adjustments for credits, cash equivalents, discount amounts, fees, refunded amounts, or any other amounts. This “gross amount” is determined on the date of the transaction.

3. **Payment Card Transactions:**
   A **payment card transaction** is any transaction in which a payment card is accepted as payment.

   A **payment card** transaction is a card issued pursuant to an agreement or arrangement that provides for (1) one or more issuers of such cards, (2) a network of persons unrelated to each other, and to the issuer, who agree to accept the cards as payment; and (3) standards and mechanisms for settling the transactions between the merchant acquiring entities and the persons who agree to accept the cards as payment.

   Payment card includes, but is not limited to, all credit cards, debit cards, and store value cards (including gift cards).

   Private label cards that can only be used at one merchant or within a group of related merchants do not meet the statutory definition of payment card because they are **not accepted by a network of unrelated persons.**

4. **Electronic Benefit Transactions:**
   Electronic benefit transactions are transactions made on cards or other media issued by a governmental unit for benefit payments, such as food stamps, unemployment benefits or welfare. A card issued by a government unit for benefits is a payment card if, pursuant to an agreement, it is accepted by a network of unrelated merchants and other statutory requirements are met.

5. **Payment Card Used to Obtain a Cash Advance**
   The use of a payment card to obtain a cash advance or loan is not a payment card transaction and is not reportable. Also, the withdrawal of cash from an automated teller machine is not a payment card transaction.

6. **Third Party Network Transaction**
   In case of a third party network transaction, the payment settlement entity is the third party settlement organization. A **third party settlement organization** is the central organization that has contractual obligation to make payment to participating payees of third party network transactions.

   A third party payment network is any arrangement that:

   (a) involves the establishment of accounts with a central organization by a substantial number of persons who (1) are unrelated to the organization, (2) provide goods or services, and (3) have agreed to settle transactions for the provision of such goods or services pursuant to such agreement;
   (b) provides for standards and mechanisms for settling such transactions, and
   (c) guarantees persons providing goods or services pursuant to an agreements or arrangement that those persons will be paid for providing those goods and services.

Healthcare networks are outside the scope of 6050W.

De Minimis threshold for a given payee, the aggregate payments for the year exceed $20,000 and the aggregate number of transactions exceed 200.

Electronic transfer of funds from the buyer to seller is not a third party payment network.

An ACH network is generally not a third party payment network. An ACH processes electronic payments between payors and payees and does not have contractual agreements with payees to use the ACH network. Thus the ACH does not meet the statutory definition of a “third party settlement organization”.

However, an entity that initiates ACH entries into an ACH network on behalf merchants may itself be operating a network that falls within the statutory definition of “third party payment network” if the entity has a separate agreement or arrangement with these merchants that:

1. involves the establishment of accounts with the entity by a substantial number of merchants or other persons who (i) are unrelated to the entity, (ii) provide goods or services, and (iii) have agreed to settle transactions for the provision of such goods or services pursuant to such agreement or arrangement;
2. provides for standards and mechanisms for settling such transactions; and
3. guarantees persons providing goods or services pursuant to such agreement or arrangement that those persons will be paid for providing such goods or services.

7. Time, Form and Manner of Reporting

Form 1099-K, Merchant Card and Third-Party Payments, requires annual reporting, with respect to each participating payee, of the gross amount of the aggregate reportable payment transactions for the calendar year and the gross amount of the aggregate reportable transactions for each month of the calendar year.

The IRS says the inclusion of monthly amounts on the return filed with the IRS and furnished to the payee will aid in reconciling payment card and third party network transactions for fiscal year payees.

8. Backup Withholding

Amounts reportable under 6050W are subject to the backup withholding requirements, effective for amounts paid after December 31, 2011. The obligation to withhold arises on the date of the transaction. A payor is not required to satisfy its withholding liability until the time that payment is made. The amount withheld is based on the total reportable amount, which is the gross amount of the transaction.

In summary, the payment card and third party network transaction reporting will generally be performed by the banks (Merchant Acquiring Entities) that are contractually liable for making the payments to the merchants. However, government electronic benefit transactions made on cards or other media issued by a governmental unit for benefit payments, such as food stamps, unemployment benefits or welfare will also be subject to this reporting requirement.

The reporting requirement for payment card transactions will fall mainly on the bank that is acting as the *merchant acquiring entity*. Thus far we have not been able to determine if State agencies/institutions are participating in third party payment networks (TPPNs) and thus have reporting obligations under these regulations. Please review your agency/institution's payment transactions to ensure you are not participating in third party payment networks. An example of a *TPPN* is pay Pal. Agencies issuing government benefit payment cards (such as for unemployment benefits) will need to ensure your third party contractor is in compliance with the reporting requirements of IRC 6050W.

There is some possibility one, or more, of the above tax provisions will be repealed, and/or, the effective date delayed. However, due to the amount of work and expense needed to fully comply with these tax provisions, it is necessary that agencies and institutions now begin the process of identifying changes needed to make their accounting systems and processes fully compliant with these federal legal tax requirements.

For agencies on the North Carolina Accounting System (NCAS), the OSC is presently working on system upgrades and modifications necessary for full compliance. We are also planning for centralized tax remission and reporting for NCAS agencies being handled out of the Office of the State Controller.

We will forward to agencies and institutions any additional information we receive related to these tax provisions. Thank you for your attention to this matter.

Should you have any questions concerning the above, please call Randy Thomas at (919) 981-5488.